No. 15,821

In the United States Court of Appeals for the Ninth Circuit

JOHN R. HANSEN and SHIRLEY G. HANSEN,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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INDEX

	Page
Opinion below	1
Jurisdiction	1
Questions presented	2
Statutes and other authorities involved	3
Statement	3
Summary of argument	7
Argument:	
I. The Tax Court correctly held that amounts withheld by GMAC in purchasing conditional sales contracts from the taxpayer, an accrual basis automobile dealer, which amounts were credited to a reserve account in his name on the finance company's books were includible in taxpayer's income in the years withheld and credited	10
II. The Tax Court properly held that taxpayer was subject to penalties for substantial underestimation of estimated tax under Section 294(d)(2) of the Internal Revenue Code of 1939	23
Conclusion	31
Appendix	32

CITATIONS

Cases:

Abbott v. *Commissioner*, 28 T.C. 798	28
Acker v. *Commissioner*, decided January 28, 1957	28
Air-Way Electric Appliance Corp. v. *Guitteau*, 123 F. 2d 20	17
Baird v. *Commissioner*, decided October 9, 1957	19
Barnwell v. *United States*, decided February 4, 1958	29
Baumgardner v. *Commissioner*, decided May 9, 1956, affirmed, 251 F. 2d 311	28
Beacham v. *Commissioner*, 28 T.C. 598	28
Blass, Guy, Co. v. *Commissioner*, 204 F. 2d 327	26

Cases—Continued Page

Bonham v. *Commissioner*, 89 F. 2d 725 22
Brewster v. *Gage*, 280 U.S. 327 25
Brodsky v. *Commissioner*, 27 T.C. 216 20
Central Motors, Inc. v. *Commissioner*, decided August 12, 1954 20
Clark v. *Woodward*, 179 F. 2d 176 11
Clayton v. *Commissioner*, decided January 25, 1956, affirmed, 245 F. 2d 238 28
Colorado Motor Car Co. v. *Commissioner*, decided March 25, 1940 20
Commissioner v. *Cleveland Trinidad Pav. Co.*, 62 F. 2d 85 22
Commissioner v. *South Texas Co.*, 333 U.S. 496, rehearing denied, 334 U.S. 813 25
Dally v. *Commissioner*, 227 F. 2d 724, certiorari denied, 351 U.S. 908 ..... 11, 12
Erwin v. *Granquist*, decided May 10, 1957, affirmed, February 13, 1958 28
Evans Motor Co. v. *Commissioner*, 29 T.C. No. 62 ..... 19, 20
Farrow v. *United States*, 150 F. Supp. 581 29
Fawcus Machine Co. v. *United States*, 282 U.S. 375 25
Fogel v. *Commissioner*, decided June 30, 1955, affirmed, 237 F. 2d 917 28
Fuller v. *Commissioner*, 20 T.C. 308, affirmed, 213 F. 2d 102 ..... 25, 28
Glover v. *Commissioner*, decided March 18, 1957 20
Helvering v. *Wilshire Oil Co.*, 308 U.S. 90 25
Helvering v. *Winmill*, 305 U.S. 79 26
Johnson v. *Commissioner*, 233 F. 2d 952 ..... 8, 23
Jones v. *Wood*, 151 F. Supp. 678 29
Kaltreider v. *Commissioner*, 28 T.C. 121 28
Keasbey & Mattison Co. v. *United States*, 141 F. 2d 163 20
Kilborn v. *Commissioner*, 29 T.C. 14 19
Koch, Wm., Motors, Inc. v. *Commissioner*, decided December 30, 1955 20
Ohmer Register Co. v. *Commissioner*, 131 F. 2d 682 17

Cases—Continued Page

Owen v. *United States*, 134 F. Supp. 31, appeal dismissed, 232 F. 2d 894 ... 29
Pacific Grape Products Co. v. *Commissioner*, 219 F. 2d 862 ... 17
Palmisano v. *United States*, decided January 22, 1958 ... 29
Patchen v. *Commissioner*, 27 T.C. 592 ... 28
Peterson v. *United States*, 141 F. Supp. 382 ... 29
Powell v. *Granquist*, 146 F. Supp. 308, affirmed, 252 F. 2d 56 ... 29
Raybestos-Manhattan Co. v. *United States*, 296 U.S. 60 ... 16
Royal Motors, Inc. v. *Commissioner*, decided July 12, 1945 ... 20
Schaeffer v. *Commissioner*, decided April 30, 1957 ... 19
Shoemaker-Nash, Inc. v. *Commissioner*, 41 B.T.A. 417 ... 11, 18, 21
Smith v. *Commissioner*, 20 T.C. 663 ... 30
Spring City Co. v. *Commissioner*, 292 U.S. 182 ... 11, 17
Stenzel v. *United States*, 150 F. Supp. 364 ... 29
Texas Trailercoach, Inc. v. *Commissioner*, 27 T.C. 575 ... 20
Texas Trailercoach, Inc. v. *Commissioner*, 251 F. 2d 395 ... 8, 23
Town Motors, Inc. v. *Commissioner*, decided July 24, 1956 ... 20
United States v. *Koppers Co.*, 348 U.S. 254 ... 30
United States v. *Ridley*, 120 F. Supp. 530 ... 29
Wayne Title & Trust Co. v. *Commissioner*, 195 F. 2d 401 ... 22
West Pontiac, Inc. v. *Commissioner*, decided February 6, 1958 ... 8, 20, 23
Whitney Corp. v. *Commissioner*, 105 F. 2d 438 ... 22
Woods, Ray, Used Cars, Inc. v. *Commissioner*, decided September 30, 1952 ... 20

Statutes:

Act of January 2, 1951, c. 1195, 64 Stat. 1136, Sec. 2 ... 26
Individual Income Tax Act of 1944, c. 210, 58 Stat. 231, Sec. 13 ... 26

Statutes—Continued | Page

Internal Revenue Code of 1939:
Sec. 22 (26 U.S.C. 1952 ed., Sec. 22) 32
Sec. 23 (26 U.S.C. 1952 ed., Sec. 23) 32
Sec. 41 (26 U.S.C. 1952 ed., Sec. 41) 32
Sec. 42 (26 U.S.C. 1952 ed., Sec. 42) 33
Sec. 294 (26 U.S.C. 1952 ed., Sec. 294) 33

Internal Revenue Code of 1954:
Sec. 166 (26 U.S.C. 1952 ed., Supp. II, Sec. 166) 38
Sec. 6651 (26 U.S.C. 1952 ed., Supp. II, Sec. 6651) 26
Sec. 6654 (26 U.S.C. 1952 ed., Supp. II, Sec. 6654) 27
Sec. 7203 (26 U.S.C. 1952 ed., Supp. II, Sec. 7203) 27

Revenue Act of 1943, c. 63, 58 Stat. 21, Sec. 118 26
Revenue Act of 1948, c. 168, 62 Stat. 110, Sec. 202 26
Revenue Act of 1950, c. 994, 64 Stat. 906, Sec. 221 26
Revenue Act of 1951, c. 521, 65 Stat. 452, Sec. 103 26
Social Security Act Amendments of 1950, c. 809, 64 Stat. 477, Sec. 208 26

Miscellaneous:

G. C. M. 9571, X-2 Cum. Bull. 153 (1931) 17
H. Conference Rep. No. 510, 78th Cong., 1st Sess., p. 56 (1943 Cum. Bull. 1351, 1372) 25
H. Rep. No. 1337, 83d Cong., 2d Sess., p. 100 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4127) 27
Rev. Rul. 55-224, 1955-1 Cum. Bull. 414 29
Rev. Rul. 57-2, 1957-1 Cum. Bull. 15 38
S. Rep. No. 221, 78th Cong., 1st Sess., p. 42 (1943 Cum. Bull 1283, 1345) 25
S. Rep. No. 1622, 83d Cong., 2d Sess., p. 135 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4769) 27

Miscellaneous—Continued Page

Treasury Regulations 111:

Sec. 29.41-1 35
Sec. 29.41-2 35
Sec. 29.294-1 25

Treasury Regulations 118:

Sec. 39.41-1 36
Sec. 39.41-2 36
Sec. 39.294-1 37

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The memorandum opinion of the Tax Court (R. 65-68) is not officially reported.

JURISDICTION

This petition for review (R. 74) involves deficiencies in federal income tax for 1951, 1952 and 1953, in the respective amounts of $1,092.66, $686.40, and $3,221.46, plus penalties,[1] for substantial underesti-

[1] In this appeal the taxpayer is not disputing the penalties imposed for failure to file declarations of estimated tax

mation of estimated tax, in the amounts of $565.10, $375.67, and $355.10. Taxpayer's income tax returns were filed with the Collector of Internal Revenue at Tacoma, Washington. On January 27, 1956, the Commissioner of Internal Revenue mailed the taxpayer a notice of deficiency in the total amount of $6,903.30, plus penalties of $3,525.11. (R. 7, 15-25.) Within 90 days thereafter, and on April 26, 1956, taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 3.) An amended petition was filed at the hearing on February 11, 1957. (R. 3, 7-25.) The decision of the Tax Court was entered on August 5, 1957. (R. 70.) The case is brought to this Court by a petition for review filed November 4, 1957. (R. 74-75.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. During 1951, 1952 and 1953, taxpayer, an accrual basis automobile dealer, assigned conditional sales contracts to a finance company in exchange for the amounts set forth in the contracts. A part of the proceeds of the sale of the contracts was withheld by the finance company and credited to a reserve account

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under 1939 Code Section 294(d)(1)(A) in the respective amounts of $847.66, $563.51 and $532.64. (R. 70; Br. 3.) For convenience, John R. Hansen will be referred to herein as the taxpayer, although Shirley G. Hansen is also a petitioner, inasmuch as she filed joint returns with her husband for the taxable years involved.

in the taxpayer's name on the finance company's books. Were the amounts withheld and credited to the reserve account income to the taxpayer in the years withheld and credited?

2. Where taxpayer filed no declarations of estimated tax in 1951, 1952 and 1953, and has conceded his liability for penalties imposed under 1939 Code Section 294(d)(1)(A), is taxpayer liable for penalties for a substantial underestimation of estimated tax for the taxable years under 1939 Code Section 294(d)(2)?

STATUTES AND OTHER AUTHORITIES INVOLVED

The applicable provisions of the Statute and other authorities are printed in the Appendix, *infra.*

STATEMENT

A portion of the facts was stipulated. (R. 5-6.) The findings of the Tax Court (R. 61-65) may be summarized as follows:

Taxpayer is a Buick automobile dealer engaged in the business of selling automobiles at retail, under conditional sales contracts providing for payment of the purchase price in installments, using a form of contract provided by the General Motors Acceptance Corporation (hereinafter referred to as GMAC). This contract called for a "Total Time Price" for the automobile sold. This price was computed by subtracting the down payment including the trade-in, if any, from the "Cash Sale Delivered Price" and adding to this difference the cost of any insurance and finance charges. Thus an amount was arrived at

called the "Time (Deferred) Balance." The down payment was added back to the latter amount to fix the "Total Time Price." (R. 61.)

The form contract included the following endorsement, which was executed by taxpayer upon assignment of the contract to GMAC (Stip. Ex. 5-E; R. 6, 39-40, 62-63):

> For value received, undersigned does hereby sell, assign and transfer to the General Motors Acceptance Corporation his, its or their right, title and interest in and to the within contract, herewith submitted for purchase by it, and the property covered thereby and authorizes said General Motors Acceptance Corporation to do every act and thing necessary to collect and discharge the same.
>
> The undersigned certifies that said contract arose from the sale of the within described property, warranting that title to said property was at time of sale and is now vested in the undersigned free of all liens and encumbrances; that said property is as represented to the purchaser of said property by the undersigned and that statements made by the purchaser of said property on the statement form attached hereto are true to the best of the knowledge and belief of the undersigned.
>
> In consideration of your purchase of the within contract, undersigned guarantees payment of the full amount remaining unpaid hereon, and covenants if default be made in payment of any instalment herein to pay the full amount then unpaid to General Motors Acceptance Corporation upon demand, except as otherwise provided by the terms of the present General Motors Ac-

> ceptance Corporation Retail Plan. Liability of the undersigned shall not be affected by any indulgence, compromise, settlement, extensions or variation of terms of the within contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise. Undersigned waives notice of acceptance of this guaranty and notices of non-payment and non-performance.

Taxpayer financed all of his conditional sales during 1951, 1952, and 1953 through GMAC. He assigned his contracts pursuant to the terms of the endorsement contained thereon, in exchange for the amount set forth in the contract, but reduced by an amount withheld and placed in a reserve account. There was no specific contract with GMAC requiring taxpayer to assign any of his contracts to GMAC. Taxpayer was not required to assign any of his contracts to GMAC or to any other finance company and could hold such contracts himself without assignment. (R. 63.)

A reserve account was maintained between taxpayer and GMAC under which at least 5% of the outstanding balances of the contracts assigned to GMAC were retained by it. This reserve was maintained in order to protect GMAC against any loss arising from the repossession of any automobile in case of default in payment. Also, in the event of prepayment by a customer, the proportionate reduction in finance charges was charged to the reserve. (R. 63-64.)

Taxpayer's books of account and income tax re-

turns were maintained and filed on an accrual method of accounting. Taxpayer had opening and closing inventories and accounts receivable. He charged off bad debts specifically as they became worthless. (R. 64.)

In reporting income from his automobile business and in maintaining his accounts, taxpayer debited the amount placed in the reserve to an account entitled "Due Finance Company" and credited an account entitled "Reserve for Repossession." In his income tax returns for 1951 and 1953 taxpayer did not include in income the amounts withheld by GMAC.[2] These amounts were placed in the reserve account. Taxpayer reported the amounts retained in the reserve account as income in the years when such amounts were paid to him by GMAC. (R. 64.)

Taxpayer did not file a declaration of estimated tax for any of the years in controversy. (R. 64.)

The Tax Court affirmed the Commissioner's deficiency determination, holding (1) that the amounts retained in the reserve account were a part of taxpayer's gross income in the years when the amounts were placed in the reserve account; and (2) that the additions to tax determined under Code Section 294 (d)(1)(A) for failure to file declarations of estimated tax and under Code Section 294(d)(2) for substantial underestimation of estimated tax were properly determined by the Commissioner. (R. 64-65.)

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[2] Taxpayer included $4,462.27 from amounts withheld in the reserve account in his gross income in 1952 and also included the same amount in 1953 income. The Tax Court made adjustment to reduce 1953 income by the duplicated amount. (R. 72.)

SUMMARY OF ARGUMENT

1. The Tax Court correctly held that amounts withheld by GMAC in purchasing conditional sales contracts from the taxpayer, an accrual basis automobile dealer, which amounts were credited to a reserve account in taxpayer's name on the finance company's books, were includible in the taxpayer's gross income for income tax purposes in the years withheld and credited. Since the taxpayer was on the accrual basis, the entire profit to him from the sale of the automobiles was properly includible in his gross income at the time of sale, even though some deferred payments would not be received until a subsequent period, and even though there was a possibility that the purchasers would default. Taxpayer's practice of accruing less than the entire sales price is inconsistent with the accrual method of accounting.

The finance company took no part in the sales, which were solely between the purchaser and the taxpayer. The transaction was complete at the time the down payment was made and the conditional sales contract executed, and at that time the taxpayer had an enforceable right to receive the remainder of the purchase price. The entire profit should be accrued at that time regardless of when received, and no portion of the profit is rendered non-taxable at that time because the contracts were sold to the GMAC under an arrangement by which a percentage of the selling price was retained as security.

There is no merit to taxpayer's argument that the amount which he will receive from the reserve ac-

count is so uncertain that he might never receive anything. Ultimately only two things can happen to the funds in the dealer reserve account, either the amounts will be paid to the taxpayer in cash or they will be used to satisfy taxpayer's other obligations to the finance company. There is no showing that the amounts in the reserve would not be collectible at the appropriate time or that their collection would be improbable.

The sale of the automobiles by the taxpayer to individual purchasers and the sale of the contracts to the finance company were separate transactions, but whether regarded as one or two transactions, in either case the only thing which would prevent the taxpayer from receiving the full sales price would be a purchaser's default, which is not a contingency sufficient to defer the accruing of income that has already been earned.

The Tax Court's decision is fully in accord with decisions of the Supreme Court, of this Court, and of the Tax Court, as well as with rulings of the Commissioner and with consistent administrative practice. It is respectfully urged that the cases of *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th); *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th); and *West Pontiac, Inc.* v. *Commissioner* (C.A. 5th), decided February 6, 1958 (1 A.F.T.R. 2d 58-839), were incorrectly decided and that they should not be followed here.

2. The Tax Court properly held that taxpayer was liable in 1951, 1952 and 1953 for penalties for substantial underestimation of estimated tax under Sec-

tion 294(d)(2) of the Internal Revenue Code of 1939. Taxpayer did not file any declarations of estimated tax in the taxable years, and he has not appealed from the addition to tax imposed by Code Section 294(d)(1)(A) for failure to file such declarations. The applicable Treasury Regulations provide that where no declaration is filed the amount of the estimated tax is zero. This provision has been sustained by the Tax Court, and is fully supported by the legislative history of the Code. It has not been shown to be unreasonable or inconsistent with the language of the Code it interprets. Moreover, the provision has been continued in the Regulations without substantial change during frequent reenactment of the Code Section involved, and Congress has never indicated disapproval of it. The Tax Court has repeatedly held that a failure to file a declaration results in a zero amount of estimated tax and that an addition for substantial underestimation may also be imposed if any tax is found to be due. Several District Courts have reached the same conclusion. The Tax Court's decision here is fully in accord with the language of the Code, with its legislative history, and with the applicable Treasury Regulations, all of which show a clear intent that both additions should be applicable for the same taxable year.

ARGUMENT

I

The Tax Court Correctly Held That Amounts Withheld By GMAC In Purchasing Conditional Sales Contracts From The Taxpayer, An Accrual Basis Automobile Dealer, Which Amounts Were Credited To A Reserve Account In His Name On The Finance Company's Books, Were Includible In Taxpayer's Income In The Years Withheld And Credited

The principal issue in this case is whether the Tax Court erred in holding that the Commissioner correctly included in taxpayer's gross income for 1951, 1952 and 1953 amounts credited to a dealer reserve account in taxpayer's name on the books of GMAC, the finance company to which taxpayer sold conditional sales contracts executed by purchasers of automobiles. Taxpayer contends (Br. 7-16) that these amounts were not includible in gross income at the time credited to the taxpayer by the finance company, and that the amounts should be accrued as income only when received, although taxpayer is on the accrual basis of accounting. (R. 64). We submit that there is no merit to this argument and that the Tax Court correctly sustained the Commissioner's determination.

Taxpayer made automobile sales under conditional sales contracts providing for payment of the purchase price in installments, the "Total Time Price" being computed by subtracting the down payment and/or trade-in, if any, from the "Cash Sale Delivered Price" and adding to this difference the cost of any insurance and finance charges. The down payment

was added to the resulting "Time (Deferred) Balance" to fix the "Total Time Price." (R. 61.)

Inasmuch as taxpayer was on the accrual basis (R. 64), the entire selling price of the automobile was includible in gross income at the time the contract with the purchaser was executed, and the entire profit remaining after the cost of the automobile was deducted was taxable net income in the year of sale. *Spring City Co.* v. *Commissioner*, 292 U.S. 182; *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417. The entire profit was taxable in the year of sale even though many of the deferred payments would not actually be received until a subsequent year (*Dally* v. *Commissioner*, 227 F. 2d (C.A. 9th), certiorari denied, 351 U.S. 908; *Clark* v. *Woodward*, 179 F. 2d 176 (C.A. 10)), and even though there was a possibility of default by purchasers of the automobiles (*Spring City Co.* v. *Commissioner*, 292 U.S. 182).

In *Clark* v. *Woodward Construction Co.*, 179 F. 2d 176 (C.A. 10th), the taxpayer had done highway construction work for the Highway Commission of Wyoming. After the work was completed and accepted by the Commission, all but 15% of the contract price was paid to the taxpayer in 1942. That 15% was withheld pursuant to a state statute in order to give 40 days notice of final settlement and acceptance of the work to persons who might have claims against the contractor. The court held that the accrual basis taxpayer should have accrued and reported the entire amount of the contract price in 1942 when the liability to it was determined and became fixed. It pointed out that, although any claims made

by third persons against the contractor would be paid from amounts withheld, any such payment would be paid from withheld money belonging to the taxpayer, and that for such payments the taxpayer could have claimed deductions.

In *Dally* v. *Commissioner*, 227 F. 2d 724 (C.A. 9th), certiorari denied, 351 U.S. 908, there was a contract between the taxpayer and the Government for the construction of prefabricated housing units, payment to be made on the basis of periodic estimates of completion of work, certified to by the taxpayer and the Government.[3] The taxpayer contended that it did not need to accrue the percentage of the contract price allocable to work performed in the taxable year inasmuch as the periodic estimates were not certified to until after the close of the taxable year. In denying taxpayer's contention, this Court stated (p. 497-8):

> The facts here bring the case within the principle of *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 295, 52 S. Ct. 529, 76 L. Ed. 1111, which holds that income may not be deferred after the right matures, even although the ministerial act of computing the amount occurs in the subsequent year, and this although

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[3] It should perhaps be mentioned that in that case 10% of the contract price was retained by the Government until final acceptance of all the work under the contract. The amount withheld, however, was not in issue in the appeal, and is in no way analogous to the dealer reserve in issue here, inasmuch as it was agreed by both parties that the right to that 10% had not matured in the taxable year since the work had not been finished and accepted.

> the administrative procedure to ascertain the amount to be paid is that of a public commission. * * * [The] mere mechanical act of making out the necessary voucher did not operate to postpone the accrual of the sum which had been earned. *Commissioner of Internal Revenue* v. *Dumari Textil Co.*, 2 Cir., 142 F. 2d 897, 899-900. Sums payable because earned are not rendered contingent and nonaccrued by the mere fact that some additional acts are necessary in order to make the collection, even if those acts must be performed later by third persons or by the government. *Automobile Ins. Co.* v. *Commissioner*, 2 Cir., 72 F. 2d 265, 267-268. Thus this court has held that a sum payable under a judgment against the United States is accruable in the year when the judgment becomes final notwithstanding Congress has yet to make the necessary appropriation to enable the judgment creditor to get his money. *H. Liebes & Co.* v. *Commissioner*, 9 Cir. 90 F. 2d 932, 939.

Because the taxpayer in the instant case was financially unable to hold the conditional sales contracts until maturity and still carry the necessary car inventories, he sold the contracts to GMAC. Each sale, however, was a transaction solely between the purchaser and the taxpayer, in which the finance company took no part. Although taxpayer used the forms of conditional sales contract furnished by GMAC, he had no specific contract with GMAC requiring him to assign any of his contracts to that finance company, or to any other finance company, and he could have held such contracts himself without assignment if he had been able to do so. (R. 33-34, 63.) Each sale

was a transaction solely between the purchaser and the taxpayer. (Ex. 5-E; R. 39.) At the time the taxpayer and the purchaser agreed on the selling price and the taxpayer received the down payment, together with the conditional sales contract for the remainder of the selling price plus finance charges, insurance, etc., the transaction was complete and the taxpayer had the right to receive the remainder of the purchase price.

Since the taxpayer used the accrual method of accounting, his entire profit from the sale should be reported when it accrued, regardless of when received. Taxpayer, however, confuses the time his enforceable right to the sales price of the automobile arose under the purchaser's agreement to buy in the taxable years involved with a later date when he would receive the entire sales price. The Commissioner contends that no portion of the profit on the sale of an automobile is rendered currently nontaxable because the taxpayer sold the contracts under an agreement by which a percentage of the selling price was retained as security by the finance company. The contracts were sold for amounts equal to the unpaid balance on the sales price. (R. 63.)

When a contract was sold the taxpayer endorsed it to the finance company guaranteeing payment of the full amount remaining unpaid. The amounts withheld and credited by the finance company to the dealer reserve account were at least 5% of the outstanding balances of the contracts assigned to GMAC. The amounts in the dealer reserve account were held to protect GMAC against any loss arising from the

repossession of any automobile in case of default in payment and also the reserve could be charged, in the event of prepayment by a purchaser, with the amount of the proportionate reduction of finance charges. (R. 63-64.) Taxpayer debited the amounts placed in the reserve by the finance company to an account entitled "Due Finance Company" and credited the amounts to an account called "Reserve for Repossession." (R. 64.) The amounts placed in the reserve were included in taxpayer's income only when they were actually received by him from GMAC. Payments to the taxpayer of amounts in the reserve in excess of approximately 5% of the outstanding balances of the contracts assigned to GMAC were made to taxpayer yearly in January or February. (R. 33.) During 1951 taxpayer failed to include $3,154.29 retained by GMAC in the reserve account, and also the sum of $12,953.97 withheld and retained in 1953. (R. 18, 21.)

The amounts set aside to the taxpayer's credit during the taxable years by GMAC were to be used to guarantee losses which might develop at some future time as a result of repossessions, but the record does not show what the incidence of loss on repossessions was during the period.

Taxpayer argues (Br. 10-11) that extreme contingencies governed payment which might prevent the dealer's receipt of any payment of the reserve. This contention is not supported by the record. While it is possible that the taxpayer would not receive cash, the reserve would in all events be used for the benefit of the taxpayer to satisfy future obligations to the

finance company. If the reserve were eliminated in the future its depletion would be due to the satisfaction of the taxpayer's liabilities to the finance company. Taxpayer confuses the arrangement with respect to *payment* of the sums in the reserve account with his absolute fixed right in the taxable years to receive definite sums credited to him at the time of sale and properly accruable at that time. The fact that the amounts in the reserve account were not immediately payable to the taxpayer is of no significance, for the important thing is that he had an enforceable right to the entire sales price of the automobiles sold during the taxable years. There was no uncertainty with respect to the amounts to which taxpayer became entitled in the taxable years. Those amounts were definitely fixed at the time they were credited by GMAC to the reserve account in his name. Only two things could ultimately occur with respect to these funds: either the amounts would be paid to the taxpayer in cash or they would be used to satisfy his other obligations to GMAC. There is no showing whatever that the amounts in the reserve accounts would not be collectible from GMAC at the appropriate time or that collection would be improbable. It thus cannot logically be argued that the reserve might never be realized by the taxpayer.

Contrary to taxpayer's contention (Br. 8-9), the sale of an automobile by the taxpayer to an individual purchaser and the sale of the contract to the finance company were two separate transactions. See *Raybestos-Manhattan Co.* v. *United States*, 296 U.S. 60. However, whether the sale of an automobile and the

sale of the contract were one or two transactions is really immaterial, for in either case the only thing that would prevent the taxpayer from receiving the full sales price would be the default of a purchaser which, as pointed out earlier in this brief, is not a contingency sufficient to defer the accruing of income that has already been earned. *Spring City Co.* v. *Commissioner*, 292 U.S. 182.

An analogous situation exists in instances where deductions have been held allowable as accrued expenses in the taxable year when all facts have occurred which determine that the taxpayer has incurred a liability. See *Pacific Grape Products Co.* v. *Commissioner*, 219 F. 2d 862 (C.A. 9th); *Ohmer Register Co.* v. *Commissioner*, 131 F. 2d 682 (C.A. 6th); *Air-Way Electric Appliance Corp.* v. *Guitteau*, 123 F. 2d 20 (C.A. 6th).

The Commissioner has consistently ruled that amounts withheld by finance companies to cover possible losses on notes purchased from dealers in trailers and automobiles constitute income to dealers using the accrual method of accounting at the time the credit is made in favor of the dealer by the finance company, even though the dealer is not immediately or even currently able to draw on the entire reserve. See Rev. Rul. 57-2, Appendix, *infra*, reaffirming the earlier ruling, G.C.M. 9571, X-2 Cum. Bull. 153 (1931). This recent ruling holds that the time for accrual of the reserve is not affected by the fact that some part or all of the reserve may be used to cover worthless notes in the future, since whenever notes become worthless the dealer's bad debt

deduction must be separately established under 1954 Code Section 166 relating to bad debts. There is no remote contingency in the present case which would distinguish it from the facts involved in that ruling. The ruling makes clear (p. 155) that a remote contingency which cannot reasonably be accrued for income tax purposes "must, however, be something more than the mere possibility of the debtor not satisfying his indebtedness." Again it states (p. 155):

> There is always a possibility, where the relationship of debtor and creditor exists, that the debtor may not pay, due to financial reverses, but if the possibility of such failure to pay is accepted as a reason for not accruing an item of income the whole theory of the accrual method of accounting must fall where commercial transactions are concerned.

The instant case does not involve the question whether taxpayer may establish a reserve for bad debts. Although Section 23(k) of the Internal Revenue Code of 1939, Appendix, *infra*, permits the deduction of either specific debts which become worthless within the taxable year or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts, the taxpayer chose to use the specific debt charge-off method for bad debt (Exs. 1-A, 2-B, 3-C; R. 5, 37, 64) and should not be allowed any further deduction.

The Board of Tax Appeals relied on G.C.M. 9571, *supra*, in *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417, where an accrual basis taxpayer sold notes received in partial payment on automobiles to

certain finance companies. Each company withheld a portion of the purchase price of the notes and credited it to the dealer on its books in a reserve account. As in the instant proceeding, the reserve was held as partial security for the dealer's obligations to the finance company. The agreement between Shoemaker-Nash, Inc., and the General Contract Purchase Corporation provided that, at any time any obligation of the dealer which was covered by the reserve became due and unpaid, the finance company could apply the reserve against the obligation. That provision is similar in all material respect to the agreement with the finance company in the instant proceeding. The Board of Tax Appeals there held that the taxpayer should report as income all amounts credited to the reserve accounts each year even though nothing was released from the accounts during the year. That case has been followed in many Tax Court decisions, which uniformly hold that dealer reserves belong absolutely to the dealer, and that provisions with respect to the *payment* of the reserves cannot serve to take from income amounts credited which would normally be determinative of his tax liability where a taxpayer is on the accrual basis. See *Kilborn* v. *Commissioner*, 29 T.C. 14, pending on appeal to the Fifth Circuit; *Evans Motor Co.* v. *Commissioner*, 29 T.C. No. 62; *Baird* v. *Commissioner*, decided October 9, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57, 192), pending on appeal to the Seventh Circuit; *Schaeffer* v. *Commissioner*, decided April 30, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,068) pending on appeal

to the Sixth Circuit; *Glover* v. *Commissioner*, decided March 18, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,045), pending on appeal to the Eighth Circuit; *West Pontiac, Inc.* v. *Commissioner*, 27 T.C. 749, reversed, February 6, 1958 (C.A. 5th) (1 A.F.T.R. 2d 58-837); *Texas Trailercoach, Inc.* v. *Commissioner*, 27 T.C. 575, reversed, 251 F. 2d 395 (C.A. 5th); *Brodsky* v. *Commissioner*, 27 T.C. 216; *Wm. Koch Motors, Inc.* v. *Commissioner*, decided December 30, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,334); *Central Motors, Inc.* v. *Commissioner*, decided August 12, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,228); *Ray Woods Used Cars, Inc.* v. *Commissioner*, decided September 30, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,290); *Town Motors, Inc.* v. *Commissioner*, decided July 24, 1946 (1946 P-H T.C. Memorandum Decisions, par. 46,173); *Royal Motors, Inc.* v. *Commissioner*, decided July 12, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,255); *Colorado Motor Car Co.* v. *Commissioner*, decided March 25, 1940 (1940 P-H T.C. Memorandum Decisions, par. 40,178).

The case of *Keasbey & Mattison Co.* v. *United States*, 141 F. 2d 163 (C.A. 3d), on which taxpayer relies (Br. 11-12), is distinguishable on its facts. See *Evans Motor Co.* v. *Commissioner*, 29 T.C. No. 62. In that case a taxpayer sold asbestos products manufactured by it to dealers and distributors, who sold to retailers or applicators, who in turn sold to home owners. Upon the termination of Federal Housing Authority financing in 1936, with respect to which

F.H.A. had guaranteed to the applicators the notes given in payment by the home owners, the taxpayer contracted with a finance company (p. 164) "to discount, for *applicators*," (italics supplied) notes of home owning purchasers of the taxpayer's products for which service the finance company was to make a charge of seven per cent of the amount of the notes so discounted. Five of the seven per cent charge was to go to the finance company as compensation for its financing services, and the balance (two per cent) was to be placed in a reserve fund by the finance company to liquidate possible losses from uncollectible notes. The contract further provided that whenever the total reserve fund should exceed ten per cent of the unpaid balance of the outstanding discounted notes such excess should be paid to the taxpayer at its option and upon termination of the agreement any balance remaining in the reserve fund was to be paid to the taxpayer. The contract also contained an express assumption of liability on the part of the taxpayer to the finance company for unpaid notes, in addition to the protection afforded by the reserve, up to ten per cent of the aggregate amounts of notes discounted. It is thus clear that the taxpayer in that case was not selling notes to the finance company as in *Shoemaker-Nash Inc.* v. *Commissioner*, 41 B.T.A. 417, and as in the instant case, but the finance company was merely discounting notes for the retailers or *applicators* of taxpayer's products. Since a materially different factual situation was involved, it is unnecessary to discuss here whether the decision of the Third Circuit was correct.

A more recent Third Circuit case is believed to be more in point here. In *Wayne Title & Trust Co.* v. *Commissioner*, 195 F. 2d 401, the court held that title insurance premiums are fully earned when received and that this characteristic is not destroyed by the requirement of Pennsylvania law that a portion of such premiums or an equivalent sum be set aside and retained in a reinsurance reserve fund. The rationale of that case is analogous to and in accord with the Tax Court's decision here. Since it is a later decision than the *Keasbey & Mattison Co.* case, it should be given more weight than the earlier decision of that Circuit.

Another analogous situation was presented in *Whitney Corp.* v. *Commissioner*, 105 F. 2d 438 (C.A. 8th), where during a reorganization there was a transfer of assets of a subsidiary corporation to a new corporation in exchange for another corporation's preferred stock, most of which was deposited with a trust company in escrow as a guaranty of stated minimum earnings of the new corporation. The court there held that the profit from the transfer was taxable in the year during which the stock was issued and deposited in escrow, at which time the rights of the parties were definitely fixed and ascertainable, not in the year when the escrow period ended. See also *Bonham* v. *Commissioner*, 89 F. 2d 725 (C.A. 8th).

Again, the case of *Commissioner* v. *Cleveland Trinidad Pav. Co.*, 62 F. 2d 85 (C.A. 6th), upon which taxpayer relies (Br. 11), is not in point here. The taxpayer there did not have an unqualified right to receive the full amount of the contract price for paving and maintaining pavements, but the municipalities

were to retain a portion to guarantee the maintenance of the pavements for the periods specified. There was no provision that the taxpayer would ultimately receive any portion of the amounts withheld. The court pointed out that the sum withheld for maintenance might be materially reduced in the event of necessary repairs or subsequent disclosure of a failure to comply with specifications. In the instant case, there was no guarantee on the part of the taxpayer to maintain the automobiles after they were sold.

The taxpayer also relies on *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th) (Br. 12); *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th) (Br. 13-15); and *West Pontiac, Inc.* v. *Commissioner*, (C.A. 5th), decided February 6, 1958 (1 A.F.T.R. 2d 58-837) (Br. 15). It is the Commissioner's position that these cases were wrongly decided, and he respectfully urges that they should not be followed as a precedent here.

It is submitted, therefore, on the basis of the record, and well-settled principles of accrual accounting the Tax Court correctly held that the amounts credited to the taxpayer in the dealer reserve account in the taxable years should properly be accrued as income in those years.

II

The Tax Court Properly Held That Taxpayer Was Subject To Penalties For Substantial Underestimation Of Estimated Tax Under Section 294(d)(2) Of The Internal Revenue Code Of 1939

Taxpayer did not file declarations of estimated tax for the taxable years 1951, 1952 and 1953. (R. 64.)

The Commissioner asserted penalties or additions to tax under Section 294(d)(1)(A), Appendix, *infra*, for failure to file declarations of estimated tax, and also under Section 294(d)(2), Appendix, *infra*, for substantial underestimation of estimated tax. (R. 17.) The Tax Court sustained the imposition of both penalties. (R. 67-68.) Taxpayer has appealed only with respect to the addition to tax imposed by Section 294(d)(2). (R. 82-83; Br. 3, 16-20.)

To Section 294(a), were added, by Section 5(b) of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, subsections (3), (4) and (5), which contain three sanctions designed to give force to the obligation there imposed on taxpayers for the first time to make declarations and payments of estimated taxes. These are additions to tax in the case of (3) failure to file timely a declaration of estimated tax; (4) failure to pay installments of estimated tax, and (5) substantial underestimation of the estimated tax.

Section 294(d)(2) provides that "If 80 per centum of the tax * * * exceeds the estimated tax * * *, there shall be added to the tax an amount * * * equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax * * *." Taxpayer argues (Br. 16-20) that because he failed to file a declaration of estimated tax he cannot be said to have underestimated it.

However, Treasury Regulations 118, Section 39.294-1(b)(3)(a) Appendix, *infra*, provides that "In the event of a failure to file the required declaration, the amount of the estimated tax for the purposes of this

provision is *zero.*"[4] (Italics supplied.)

Treasury Regulations must be sustained unless unreasonable and plainly inconsistent with the statute which they interpret; they are not to be overruled except for weighty reasons. *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501, rehearing denied, 334 U.S. 813; *Fawcus Machine Co.* v. *United States*, 282 U.S. 375, 378; *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 103; *Brewster* v. *Gage*, 280 U.S. 327.

The leading Tax Court decision, *Fuller* v. *Commissioner*, 20 T.C. 308, affirmed on other issues, 213 F. 2d 102 (C.A. 10th), rejected attack on the above Treasury Regulations in the following language (p. 316):

> The petitioners attack the regulation as being void in that it "distorted the will of Congress." The regulation is couched in the same language used by Congress in its Conference Report on legislation covering this subject and follows the procedure therein prescribed. It therefore appears that the regulation actually reflects, rather than distorts, the will of Congress, and we uphold its validity.

Both the Senate Report and Conference Report (S. Rep. No. 221, 78th Cong., 1st Sess., p. 42 (1943 Cum. Bull. 1283, 1345); H. Conference Rep. No. 510, 78th Cong., 1st Sess., p. 56) (1943 Cum. Bull. 1351, 1372) provided as follows:

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[4] The same provision appears in Treasury Regulations 111, Section 29.294-1 (b) (3) applicable to the taxable year 1951.

> In the event of a failure to file any declaration where one is due, the amount of the estimated tax for the purposes of this provision will be zero.

Moreover, Treasury Regulations "long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Gus Glass Co.* v. *Commissioner*, 204 F. 2d 327 (C.A. 8th). Congress has seen fit substantially to re-enact the sections here involved several times since 1943.[5] It has in no way indicated disapproval of the Treasury Department's interpretation of the statute as reflected in its Regulations. The re-enactment doctrine should have, therefore, considerable force. *Helvering* v. *Winmill, supra.*

That the additions to tax may be imposed for both failure to file a declaration and for a substantial underestimate in the same taxable year is also shown by the Committee Reports to the 1954 Code. The 1954 Code eliminated the addition to tax for failure to file a declaration (Section 6651(c) (26 U.S.C. 1952 ed., Supp. II, Sec. 6651)) except in the case of wilful

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[5] The following amendments and re-enactments have been made to these provisions without disturbing the regulative provision here in dispute. Section 118(a), Revenue Act of 1943, c. 63, 58 Stat. 21; Section 13(a), Individual Income Tax Act of 1944, c. 210, 58 Stat. 231; Section 202(a), Revenue Act of 1948, c. 168, 62 Stat. 110; Section 2, Act of January 2, 1951, c. 1195, 64 Stat. 1136; Section 208(d)(4), Social Security Act Amendments of 1950, c. 809, 64 Stat. 477; Section 221(g), Revenue Act of 1950, c. 994, 64 Stat. 906; and Section 103(b), Revenue Act of 1951, c. 521, 65 Stat. 452.

failure (Section 7203 (26 U.S.C. 1952 ed., Supp. II, Sec. 7203)). The 1954 Code combined the three additions into a single one for underpayment of the estimated tax and based the addition upon six per cent per annum of the amount of the underpayment for the period of the underpayment. Section 6654 of the 1954 Code (26 U.S.C. 1952 ed., Supp. II, Sec. 6654).

In explaining this change the Committee Reports point out that under the 1939 Code additions to tax for failure to file a declaration and for a substantial underestimate would both apply for the same taxable year, stating (H. Rep. No. 1337, 83d Cong., 2d Sess., p. 100 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4127):

> Additional charges are imposed under the present law for failure to file a declaration or make a payment of the estimated tax or for substantial underestimates of tax liability. These charges may be severe. For failure to file a declaration or to pay an installment of the estimated tax, the total charge may be as high as 9 percent of the unpaid installment. For a substantial underestimate of tax, that is, an estimated tax which is less than 80 percent of the actual tax liability for the year (66⅔ per cent in the case of farmers), a charge of 6 percent of the amount by which the final tax liability exceeds the estimated tax may be imposed. This charge and the charge for failure to file a declaration or pay an installment of estimated tax may run concurrently and result in a combined charge of 15 percent of the estimated tax due.

See also S. Rep. No. 1622, 83d Cong., 2d Sess., p. 135 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4769).

In conformity with the above legislative history and Regulations, the Tax Court has repeatedly held that a failure to file a declaration results in a zero amount of estimated tax, and that an addition for a substantial underestimate may also be imposed if any tax is found to be due. Following are a few of the Tax Court decisions: *Fuller* v. *Commissioner*, 20 T.C. 308, affirmed on other grounds, 213 F. 2d 102 (C.A. 10th); *Baumgardner* v. *Commissioner*, decided May 9, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56, 112), affirmed on other grounds, 251 F. 2d 311 (C.A. 9th); *Clayton* v. *Commissioner*, decided January 25, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,021), affirmed, 245 F. 2d 238 (C.A. 6th); *Fogel* v. *Commissioner*, decided June 30, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,185), affirmed, *per curiam*, 237 F. 2d 917 (C.A. 6th); *Acker* v. *Commissioner*, decided January 28, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,017), pending on appeal to the Sixth Circuit; *Abbott* v. *Commissioner*, 28 T.C. 798, pending on appeal to the Third Circuit; *Patchen* v. *Commissioner*, 27 T.C. 592, pending on appeal to the Fifth Circuit; *Kaltreider* v. *Commissioner*, 28 T.C. 121, pending on appeal on other issues in the Third Circuit; *Beacham* v. *Commissioner*, 28 T.C. 598, pending on appeal on other issues in the Fifth Circuit.

Several District Courts have reached the same conclusion as the Tax Court. *Erwin* v. *Granquist* (Ore.), decided May 10, 1957 P-H, par. 72,786), affirmed, *per curiam*, February 13, 1958 (C.A. 9th) (1 A.F. T.R. 2d 58-978), taxpayer's petition for certiorari

pending; *Palmisano* v. *United States* (E.D. La.), decided January 22, 1958 (1 A.F.T.R. 2d 58-934), pending on appeal to the Fifth Circuit; *Farrow* v. *United States*, 150 F. Supp. 581 (S.D. Cal.); *Peterson* v. *United States*, 141 F. Supp. 382 (S.D. Tex.). It is true, as taxpayer notes (Br. 18-19), that a few District Courts have held that the addition to tax under Section 294(d)(2) cannot be applied where no declaration of estimated tax was filed. These cases stem from *United States* v. *Ridley*, 120 F. Supp. 530 (N.D. Ga.), decided in 1954. See also *Barnwell* v. *United States* (E.D. S.C.), decided February 4, 1958 (1 A.F.T.R. 2d 58-995); *Jones* v. *Wood*, 151 F. Supp. 678 (Ariz.); *Stenzel* v. *United States*, 150 F. Supp. 364 (N.D. Cal.); *Powell* v. *Granquist*, 146 F. Supp. 308 (Ore.), affirmed on another issue, 252 F. 2d 56 (C.A. 9th); *Owen* v. *United States*, 134 F. Supp. 31 (Nebr.), appeal dismissed, 232 F. 2d 894 (C.A. 8th).

The Revenue Service has announced it will adhere to *Fuller* v. *Commissioner*, *supra*, and will not follow *United States* v. *Ridley*, *supra*. Rev. Rul. 55-224, 1955-1 Cum. Bull. 414.

The District Court in *Ridley*, *supra*, reasoned that both sanctions could not stand and therefore that the lesser (Sanction 294(d)(2)) should fall on the theory that no estimate had been made. The results that may flow from the *Ridley* decision are well illustrated by *Jones* v. *Wood*, 151 F. Supp. 678 (Ariz.). There taxpayer filed no declarations of estimated tax. The District Court first held, following *Ridley*, that the impost under Section 294(d)(2) could not stand; then it held the addition to tax under Section 294(d)

(1)(A) was excused on the grounds of reasonable cause. Thus, taxpayer paid nothing for failing to obey the law and retaining use of the money.

If Congress had not intended both sections to apply it could easily have so provided. The addition to tax for failure to pay, as provided in Section 294(d)(1)(B), is expressly limited to cases where a declaration of estimated tax was filed. Section 294(d)(2) has no similar provision making the penalties interdependent.

Section 294(d)(1)(A), which imposes an addition to tax for the failure to file, may not always apply as *Jones* v. *Wood*, *supra*, illustrates, for it may be excused on a showing of "reasonable cause." The Tax Court found reasonable cause lacking in the instant case. (R. 65.) Section 294(d)(2), however, contains no exculpatory language, which leads to the conclusion that Congress intended it to apply automatically whenever taxpayers failed by 20% or more to meet the statute's obligation. *Smith* v. *Commissioner*, 20 T.C. 663. It is not sensible to penalize the person who tries but misses by 20% regardless of reason (*Smith* v. *Commissioner*, *supra*), but to let go altogether the person who does not even file a declaration, if he had an excuse for his failure, as the court did in *Jones* v. *Wood*. Cf. *United States* v. *Koppers Co.*, 348 U.S. 254, 263.

We submit that the Tax Court and District Court decisions which apply both additions are clearly correct, and that they are fully in accord with the language of Section 294(d)(1)(A) and (d)(2), with the legislative history of the section's enactment and

with the applicable Treasury Regulations, all of which show a clear intent that both additions should be applicable for the same taxable year.

CONCLUSION

For the reasons stated, the decision of the Tax Court is correct and should be affirmed.

Respectfully submited,

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APPENDIX

Internal Revenue Code of 1939:

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits and income derived from salaries, wages, or compensation for personal service, or whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

* * * *

(k) [as amended by Sec. 113(a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Bad Debts.*—

(1) *General rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period

(fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such methods as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.
(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 294. ADDITIONS TO THE TAX IN CASE OF NONPAYMENT.

* * * *

(d) [as added by Sec. 118(a), Revenue Act of 1943, *supra*] *Estimated Tax.*—

(1) [as amended by Sec. 13(b) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231] *Failure to file declaration or pay installment of estimated tax.*—

(A) *Failure to File Declaration.*—In the case of a failure to make and file a declaration of estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of each installment due but unpaid, and in addition, with respect to each such installment due but unpaid, 1 per centum of the unpaid amount thereof for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment. For the purposes of this subparagraph the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits under sections 32 and 35.

* * * *

(2) [as amended by Sec. 6(b)(8) of the Individual Income Tax Act of 1944, *supra*] *Substantial underestimate of estimated tax.*—If 80 per centum of the tax (determined without regard to the credits under sections 32 and 35), in the case of individuals other than farmers exercising an election under section 60(a), or 66⅔ per centum of such tax so determined in the case of such farm-

ers, exceeds the estimated tax (increased by such credits), there shall be added to the tax an amount equal to such excess, or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser. This paragraph shall not apply to the taxable year in which falls the death of the taxpayer, nor, under regulations prescribed by the Commissioner with the approval of the Secretary, shall it apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter (excluding, in case the taxable year begins in 1943, any quarter beginning prior to July 1, 1943) of such year (or in the case of farmers exercising an election under section 60(a), within the last quarter) in an amount at least as great as though computed (under such regulations) on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of the filing of the declarations for such taxable year (or in the case of any such farmer, or in case the fifteenth day of the third month of the taxable year occurs after July 1, on July 1 of the taxable year) but otherwise on the basis of the facts shown on his return for the preceding taxable year.

* * * *

(26 U.S.C. 1952 ed., Sec. 294.)

Treasury Regulations 118,[6] promulgated under the Internal Revenue Code of 1939:

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[6] Treasury Regulations 111, Sections 29.41-1, 29.41-2 and 29.294(b)(3)(4), applicable to the year 1951, are substantially similar to the quoted sections from Treasury Regulations 118.

Sec. 39.41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items or gross income and deductions are to be accounted for. (See sections 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 39.41-2 *Bases of computation and changes in accounting Methods.*—(a) Approved standard method of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistence. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly unless in order clearly to re-

flect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 39.42-2 and 39.43-3.) On the other hand, appreciation in value or property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 39.22(c)-5.)

* * * *

Sec. 39.294-1 *Additions to the tax.—*

* * * *

(b) *Additions for specific failures on the part of the taxpayer with respect to the estimated tax—*

* * * *

(3) *Substantial understatement of estimated tax.* (1) Section 294(d)(2) provides for an addition to the tax in the case of a taxpayer who makes a substantial underestimate of tax on his declaration. Such addition to the tax shall not apply to the taxable year in which falls the death of the taxpayer. Except as hereinafter provided—

(a) In the case of individuals, other than those exercising the election under section 60(a), relating to farmers, an addition to the tax under section 294(d)(2) is applicable in the event that the amount of the estimated tax (increased by the

amount of the credit for taxes withheld at source on wages under section 35 and the credit under section 32) is less than 80 percent of the tax imposed by chapter 1 for the taxable year (determined without regard to such credits). In the event of a failure to file the required declaration, the amount of the estimated tax for the purposes of this provision is zero.

*   *   *   *

Rev. Rul. 57-2, 1957-1 Cum. Bull. 17:

Rev. Rul. 57-2

Amounts withheld by banks or finance companies to cover possible losses on notes purchased from dealers constitute income to dealers employing accrual method of accounting, to the extent of their interest therein at the time the amounts are recorded on the books of the bank or finance company as a liability to the dealer, regardless of whether charges for worthless notes are also made to the account pursuant to an agreement between the parties. Losses sustained on worthless notes shall be separately established by the dealer as required by section 166 of the Internal Revenue Code of 1954.

The Internal Revenue Service has been requested to state its position with respect to the treatment, for Federal income tax purposes, of amounts withheld by banks and finance companies to cover possible losses on notes purchased from automobile or other dealers employing the accrual method of accounting, and which are recorded on the books of the bank or finance company as a liability of the bank or finance company to the dealer.

The steps generally involved in transactions concerning automobile dealers are as follows: When a car is purchased on credit from a dealer, the purchaser makes a down payment, either in the form of cash or by turning in another car at an agreed value, the balance being satisfied by the purchaser's promissory note and a supporting conditional sales contract. The face amount of the note reflects two elements—the balance of what would be the purchase price of the car, if bought for cash, and a finance charge. As between the purchaser and the dealer, the transaction is closed and completed at this point with the attendant tax consequences to the dealer.

It is then common practice for the dealer to sell or discount the purchaser's note and sales contract to some financial institution. The finance company or bank acquires the note at a value somewhat less than its face value, the difference representing a charge for its service. Simultaneously, either cash or unrestricted credit is given to the dealer to the extent of the amount reflected in the face value of the note. That corresponds to the unpaid balance of the cash retail price of the car. The difference between the face value of the note and the sum of the finance company's charge and its credit or immediate payment to the dealer (representing part of the finance charge previously mentioned) is then credited on the books of the finance company as a liability of the finance company to the dealer. The accumulation of these credits is generally known as a "dealers reserve" and is the specific object of the present consideration.

Settlement of the liability represented by the reserve is subject to agreement between the particular dealer and the financial institution involved. In some instances, the agreement does not contemplate the charging of any items against the reserve account,

while in others the account reflects a running record of various transactions between the parties, that is, both credits and charges are entered, depending upon the nature of the item. Thus, in certain instances, the dealer and the finance company may agree that notes purchased or discounted are to be charged to the reserve account in the event they become worthless.

With regard to those instances where losses incurred by a finance company on the notes purchased from automobile dealers may not be charged against the reserve, the credits to the reserve, by the finance company in favor of a dealer who employs the accrual method of accounting constitute income to the dealer at the time such credit is made, even though the dealer is not immediately or even currently able to draw on the entire reserve. See G. C. M. 9571, C. B. X. 2, 153 (1931), and *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B. T. A. 417. The principles involved in the purchase of notes from automobile dealers by banks or finance companies as described above are equally applicable where notes are purchased, under similar conditions, from dealers in items other than automobiles.

Where a dealer's reserve is in the nature of a running account, the charging thereto of worthless notes pursuant to agreement between the parties has no bearing upon the fact that taxable income has been received by the dealer, or upon the time of its realization as otherwise evidenced by the credits to such reserve.

Accordingly, it is held that credits to such reserve, in the case of a dealer employing the accrual method of accounting, constitute income to the dealer at the time such credits are made regardless of whether changes to the account for worthless notes are also made pursuant to an agreement between the parties.

Losses sustained on worthless notes are to be separately established by the dealer as required by the provisions of section 166 of the Internal Revenue Code of 1954 relating to bad debts.

In arriving at these conclusions, consideration has been given the case of *Blaine Johnson et al* v. *United States*, 233 Fed. (2d) 952. See also, *Albert M. Brodsky, et us.* v. *Commissioner*, 27 T.C. No. 23.

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